PRINCIPLES OF EXCESS PROFITS TAXATION

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The following paper deals with a few of the larger problems of the excess profits tax; its scope and character, the general principles upon which it rests and with whose validity it must eventually stand or fall. In discussing these topics I speak not only unofficially, but tentatively; I express only my personal opinions, and those opinions are subject to later revision.

I

The excess profits tax law itself fairly bristles with legal and administrative difficulties. Section 210, for instance, considering cases in which the administrative authorities are unable satisfactorily to determine the invested capital, provides another and a satisfactory method of determining the deduction, but says nothing about the rates of taxation which depend, in a very important way, upon the amount of invested capital itself—which amount, this very section assumes it is impossible satisfactorily to compute. In other words, at this part of the law there is an open chasm. The law, as it were, starts to bridge a gulf but terminates abruptly when we are half way across.

This is but one of the scores of problems raised by the excess profits tax law. It would be useless to attempt to settle them here. I mention them merely to suggest that any judgment of the fundamental character of such a law must be a charitable judgment. We must expect some inconsistencies. Any interpretation of the fundamental purpose and intent of the law will be sufficient if it harmonizes and synthesizes its main provisions.

The unusual technical difficulties of the excess profits tax have brought about a significant change in the administrative procedure of the Treasury Department. Breaking boldly with past departmental practice, the Secretary of the Treasury has sought to enlist the coöperation of the taxpayers themselves and has appointed a group of Excess Profits Advisors to assist the Commissioner of In-

ternal Revenue in construing and applying the law. This is an administrative departure so striking as to be almost revolutionary. Hitherto the taxpayer and the tax gatherer have held each other at arm's length. We have, as a people, come to look upon the taxpayer with suspicion, and the belief has grown up that the word of the taxpayer, or even his oath on a tax return, is likely to be untrustworthy and misleading. The great war in which we are now engaged, along with indescribable evils, has brought some priceless boons, chief of which is a deeper recognition of the necessity of coöperation. We must work together lest we all go down in the general collapse of democratic government. And among the forms and varieties of coöperation, the strangest perhaps, and not the least attractive, is the proposed coöperation between those who pay and those who collect taxes. Tax paying and tax gathering may be made different and far more wholesome things if this experiment with the Excess Profits Advisors be successfully carried out.

II

"This title," the excess profits tax law reads, "shall apply to all the trades or businesses of whatever description, whether continuously carried on or not. . . ." The tax, therefore, is laid upon trade or business. But a preceding paragraph provides that every corporation or partnership not specifically exempt shall be deemed to be engaged in business, and that all its income, from whatever source derived, shall be deemed to be received from such trade or business. In the case of partnerships and corporations, there is but one business, one income; and the latter, with some specific exceptions, is the income returned for purposes of income tax.

In the case of the individual, however, the situation is probably different. True, professions and occupations are specifically included in the general category of trade or business, and we all know by this time that the excess profits tax applies to salaries. But in all probability, the tax does not cover, in the case of the individual, income derived from mere ownership, in which the element of active business management or personal exertion is substantially absent. In the debate upon the excess profits tax in the House of Representatives, Mr. Cannon pointedly asked whether income derived by "a

gentleman of leisure," as such would be subject to the excess profits tax. Mr. Kitchin replied with an emphatic negative:

> I do not think in the case the gentleman cites that the individual would pay any excess profits tax, as he is not engaged in trade or business and has no profession or occupation. He, of course, would pay an income tax. The difference between the excess profits tax and the income tax is this: The income tax is upon the total net income received from all sources, with a few certain exceptions. The excess profits tax as now written in the bill is a tax on trade or business, including professions and occupations; that is, on the income or profits of trade or business, including professions and occupations.
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> But if an individual is in business—say in the mercantile business—and has investments in railroad stocks and bonds and receives $10,000 from them, disconnected altogether from his business, that would not be included in determining the income subject to excess profits tax.

The fortunate individual, therefore, who "lives upon the income from his capital," will not be subject to excess profits tax, if Mr. Kitchin's interpretation of the law be correct. The salaries or fees of the typical professional man, the brain worker, are taxed. The man who risks his capital and puts his energy into a competitive business of the ordinary kind is taxed. But he who lives quietly on his rents, his dividends and his interest receipts, is not taxed.

Indeed, the whole status of the investor under the war revenue bill is a significant one. The income which he derives from securities may be subjected to very heavy income tax. But the new income tax law, in a section which I shall not quote in detail though it deserves careful exegesis, provides with significant exceptions that dividends shall be taxed to distributees at the rates prescribed by law for the years in which the profits or surplus (from which they are paid) were accumulated by the corporation. As a result of this provision, millions of dividends distributed this year will not be subject to the heavy war income taxes but will pay at the lower rates applicable in the past. Moreover, in its final formulation, the war revenue bill omitted a clause previously adopted by the Senate which prohibited those contracts by which the borrower or debtor undertakes to pay any tax imposed upon the interest or income going to the lender or creditor. This, I say, was stricken out. The result is congressional endorsement of a practice which, in most foreign countries, is regarded as contrary to sound public policy. We encourage, in short, the multiplication of those covenants by which debtors undertake to pay taxes levied in the first instance upon creditors.

I raise these questions concerning the status of the investor in the scheme of war taxes, not for the purpose of criticism, but to bring into clear relief some of the larger aspects of our general tax policy. So far as dividends and the excess profits tax are concerned, the case is clear. The corporation from whose earnings dividends are paid, being duly subject to excess profits tax, the individual may with logic be exempt. So far as interest from bonds is concerned, it is plain that, so long as the individual is accorded a deduction of 7 to 9 per cent upon his invested capital, the inclusion of bond interest among the other items of taxable income or profits would be fruitless. The Treasury is better off with interest omitted from income and principal excluded from invested capital.

And yet, a doubt persists. Is a scheme of taxation sound which imposes heavy taxes upon the salaried man, or the man who stakes his time and money in the hazardous game of business, and yet shields the man who lives upon the income from his capital? Here are three men, each with an income of $100,000 a year. A has little or no capital, except his brains and technical equipment which will disappear at his death. He is taxed. B puts $100,000 in a risky business which, at the present, pays generously. He is even more heavily taxed. C inherited two and a half million dollars from his father, invested perhaps largely in state, municipal and federal bonds. He pays little or no tax, local, state or federal. Speaking generally, a given income backed by a very large amount of capital ought, it might seem, to be more heavily taxed than the same amount of income backed by a small capital. Yet our excess profits tax, in company with a majority of such taxes in other countries, proceeds on a different principle. "To him that hath shall be given, and from him that hath not shall be taken away even that which he hath."

When a suitable opportunity occurs Congress should, I believe, impose a differential tax on "unearned" income. This would remedy what seems to be a marked defect in our existing scheme of federal taxation. At the same time income derived from personal exertion should be given further study. Corporations already have the right to deduct the salaries of officers. The same right should be given to partnerships and sole proprietors, although the estimated salaries would have to be "reasonable."

III

The line of thought which we are here pursuing leads inevitably to a challenge or criticism of most direct taxes imposed upon business or the business unit. Let me illustrate. Here are two corporations, each with the same capital and the same net earnings; but corporation A is owned by a large number of small investors (working men and mechanics perhaps), while corporation B is owned by three millionaires. Drastic taxation on the profits of A and B will have very different effects upon the two sets of stockholders. The mechanics and working men who jointly own A will be deprived of extra war dividends which they may really need to meet the increased cost of living; whereas the owners of B will merely be deprived of unnecessary luxuries or the wherewithal to make new investments. The challenge or criticism under discussion amounts then to this: that an income or excess profits tax of any variety upon a business unit is illogical; that its principal incidence and burden are upon the stockholders; that there may be relatively strong stockholders in weak corporations and very weak shareholders in strong corporations; that so far as possible, we should avoid the intermediary, the agent, the go-between, and employ only the personal income tax. At the basis of this criticism will be found an assumption, conscious or unconscious, that all direct taxes are to be judged by the ability standard—to be accepted or condemned according as they conform to, or depart from, the principle of taxation in accordance with ability to pay.

At this point it is pertinent to note that the difficulty under discussion is not to be remedied by any substitution of the war profits principle for the excess profits principle, of the English for the American method of computing the tax.

Here are two corporations, each with $1,000,000 capital and each earning $300,000 a year during the war, but whereas corporation X earned $200,000 in the normal, or average year before the war, corporation Y earned only $80,000. Under the English law, with its pre-war income standard, corporation Y would be taxed very much more heavily than corporation X, which is in reality the stronger corporation. Both corporations earn the same amount during the war, but the one which was more prosperous in the past, the one which has accumulated the larger revenues, the larger surplus against a rainy day, would, under the English law, pay the

smaller tax. As a matter of principle, neglecting the practical difficulties of applying the capital standard, it is difficult to see any superiority in the English method of war profits taxation. Does pre-war prosperity establish just ground for exemption or immunity during the war? Do not extra war profits added to a high level of pre-war profits create an unusual capacity to bear taxes, rather than the reverse? If you and I are equally prosperous today, but I have been prosperous much longer than you, is my longer prosperity sufficient reason for levying a smaller tax upon me than you?

As a matter of theory, and in the average or normal case, I believe that these two standards, the income standard and the capital, are essentially similiar. In the long run, the real invested capital depends upon normal earnings. Our illustration of corporation X and corporation Y was in fact false and misleading. It represents an impossible case. If corporation X had enjoyed profits of $200,000 a year as a regular and normal thing before the war, its true invested capital could not, except by accident, have remained at $1,000,000. Its capital assets, tangible and intangible, would have come to be worth $3,000,000 or more; they could have been sold for that amount; and individual investors would have bought stock on that basis. In the normal case, the income and capital standards are, when properly interpreted, practically the same.

But we must get away from the "original investment." Where mature and well-developed corporations are concerned that concept has little meaning. The original investment has no permanence. It changes inevitably. Durable assets, such as land and buildings, depreciate and appreciate; and these variations may at times be taken up on the books and they will certainly be taken into account in any case of sale or consolidation. Intangible assets are built up and in turn disappear. The true capital, the true investment, changes with the shifting level of income and with future prospects based upon such income. Of course, if we take only the income of two or three years before the war, there is no necessary correspondence between such income and the true capital of the business. But what chanced to happen in the three years which preceded the outbreak of the war is not and should not be controlling in this connection. Even if we accept the pre-war profits standard, its logic requires that we ascertain pre-war earnings over a sufficient number of years to obtain a true or normal average; and over such a series

of years no industry, except a monopoly, can earn upon its true capital an abnormal rate of profits. In short, if we could satisfy in practice the logical requirements of both methods it would make little difference in the vast majority of cases whether we employed the income or the capital basis.

IV

The American excess profits tax of October 3, 1917, was passed after a stubborn and protracted legislative contest, in which one idea, vaguely called the excess profits principle, triumphed over another idea usually referred to as the war profits principle. This victory of "excess profits" over "war profits" is very significant. Its significance does not lie in the substitution of a deduction of exemption based upon capital for one based upon income. As has just been pointed out, these two methods are in the last analysis, if consistently applied, so closely related as to be almost one and the same. The significance of the American law, or of its adoption, lies in the fact that it represents a deliberate rejection of a pre-war standard in favor of a normal standard. War profits taxes must, it would seem, be short lived. An excess profits tax might, conceivably, become a permanent fixture in our financial system. Base the tax on excess of present earnings over pre-war earnings, and with each passing year the basis of the tax becomes more antiquated, more impossible. Base the tax upon excess over a fair return on the investment, properly measured to start with, and with each passing year the tax may become sounder and more equitable. The government asserts, as it were, a right to share in any abnormal or unusual profits realized by the business man. This is at once the peculiar promise, or the peculiar menace, or the peculiar scientific interest of the American excess profits tax—as you are inclined to look at it. It is likely to prove the most revolutionary development in public finance since the introduction of income taxation.

V

If the tax is to endure it must meet the fundamental criticism mentioned in the beginning, that, in common with most taxes imposed upon the business unit, it does not conform to the principle of ability to pay.

It is a shallow and narrow interpretation of this principle that

tests its every application by the effect of the tax upon the consumer; which surveys man, the taxpayer, only as one who clothes his back and feeds his body. There are many valid varieties of this great principle of taxation and among them are those which survey the taxpayer in his capacity of producer, which take the business man in his economic and political environment, which recognize the truth that the state and community stand as silent partners in every business enterprise, which make a permanent place in our revenue system for a tax designed to take for the community a fair portion of all profits in excess of the amount required to elicit the requisite investment of capital. Such a tax would be in true conformity with the ability principle; it would spare the infant industry; it would spare all industries during periods of depression; it would encourage industrial experimentation; and would lay the heaviest burden upon those who have been most fortunate. It solves, in a reasonably satisfactory way, the difficult question of finding a graduated or progressive tax for business enterprise. It may possibly supply, what is even more difficult to find, a practicable and equitable method of business taxation.

The tax contains, like most good ability taxes, a distinct element of the benefit principle. The English courts have decided that the English excess profits tax represents the state's share in the profits of private business; and the American law—by refusing to permit the deduction of an excess profits tax as a business expense of the year in which paid—apparently partakes of the same character. It is not a tax upon the individual to be judged by the sacrifices which it imposes upon him, but the prior claim of the state upon private profits which public expenditures, or public misfortunes, or the general environment maintained by the state, have in part produced. The government's claim to part of the profits, particularly in time of war, is so strong as to justify the statement that the stockholders have no claim on profits until the government has released them. When a special assessment or betterment tax is imposed, no cognizance is taken of the individual's ability to pay. For much the same reason, when an excess profits tax is levied upon a corporation or partnership, no cognizance need be taken of the tax paying ability of the shareholders. We must have business taxation because business units, as such, benefit by the activities and expenditures of the government; because they have, as business

concerns, differing "abilities" to pay; because the state cannot wait for the distribution of profits from the business source to the ultimate recipients; and because taxes levied at the business source are far less expensive to collect, and far more productive in yield, than those levied upon the individual partners or shareholders in business organizations.

VI

What I have been considering is the eminently practical problem of the future of the excess profits tax; will it endure—should it be permitted to endure after the war?

I do not pretend to give the final answers to these questions even in my own mind. But they are questions about which we should begain to think seriously. It is sometimes said that the country which imposes an excess profits tax after the war will so hamper its business as to deny it any share in the international trade of the world; in short, that it will place domestic industries at a disadvantage in competing with foreign industries.

Whether this criticism be sound or unsound depends upon many factors, among which must be included the relative burden of all taxation in this country as contrasted with foreign countries; the equity and care with which this and other taxes are formulated and administered; and most of all upon the truth of the theory upon which the tax rests. It is either true or not true that the success of business enterprise depends, in part, upon the helpful participation of the state. This is either genuine truth or humbug. If it be a genuine truth, business can afford to pay for the assistance of the state. If it be merely false and hollow rhetoric, American business enterprise will fall before foreign competitors which do have the real support of their respective governments. In general, what business fears is not heavy taxation, but unjust and discriminatory taxation, careless taxation, bungling attempts to do the impossible, inconsistent taxation, the unlike treatment of like business situations.

Such a tax might serve appreciably to allay hostility to big business by making the people a partner in the success of big business. As pointed out several years ago by Henry C. Adams, such a tax fits in harmoniously with the policy of rate regulation or price regulation. We shall probably have more of such regulation as time goes on; and this regulation must, in all probability, be accom-

plished through general rules which, adapted to the less favorably situated producers, yield excessive returns to the more favorably situated producers. Under such circumstances, a tax upon excess profits makes the results of price regulations more equitable and more attractive. Some such device as this would appear to promote individualism and private industry. Not only land sites, as Henry George emphasizes, but other commercial and industrial opportunities differ enormously. We cannot give to each industry the same opportunities of location, proximity to markets, good shipping facilities, good credit institutions and good government; but we can make inequalities a little less by imposing a tax upon the differential product—upon excess profits. Conceivably then, the excess profits tax may assist materially to promote that equality of opportunity which is as necessary to good business as to good citizenship.

Lack of productivity will probably prove the gravest weakness of the excess profits tax as a permanent part of the tax system. In normal years we cannot expect a tax upon supernormal profits to yield the enormous revenue which we expect to derive from this source during the war. And yet, it is probable that even in lean years the tax would supply a revenue altogether worth while. In our vast country it seldom or never happens that all sections and all industries move together. When there is drought or financial depression in one part of the country, other sections enjoy abundant crops and prosperous business conditions. Where an epidemic prevails the doctors, at least, do a thriving business. There will always be some excess profits to tax.

But if the tax is to succeed, we must solve this problem of establishing a sound normal basis from which to measure the excess. In determining this normal datum line we can, as has been stated, use either past income or invested capital; indeed the difficulties are so great that we should make use of both. It would be theoretically possible, for instance, to take the income for a considerable number of years, exclude the abnormal years and accept the remainder as our datum line. But even in this case we should have to make allowances for the increase in capital; and for this and other reasons, the United States, in contrast with most of the other thirteen or fourteen countries imposing the excess profits tax, prefers to start with the capital basis.

Even with this basis we are forced to rule out those capital assets which are the product of abnormal conditions. For instance, no serious consideration was ever given, or could practically have been given, to the proposition that the capital basis of the tax should reflect the abnormal profits earned during the war.

In getting rid of abnormal capital items, however, many of those interested in this subject have gone to the other extreme. They believed that capital should be taken or valued as of the time of original investment. Curiously enough, it may be said parenthetically, this principle is adopted in the English law in so far as that law makes use of a deduction based upon capital. The difficulties engendered by starting with the original investment are enormous. Some corporations are fifty years old or more and the exact amount of cash or tangible property paid in, and the circumstances surrounding such payment, have disappeared in the mists of time. On the other hand, many corporations have gone through formal or genuine reorganization within the past few years. Some old corporations have written upon their books the appreciation which has taken place in their real estate and other property. Other old corporations have not done this. Some corporations have so handled advertising and similar costs that they stand on the books as capital assets, designated "good will," "trade-marks," and the like. Many other corporations, having brands or similar intangible assets of great value, have written off as current expense the advertising and similar expenditures made to develop or create these intangible assets. Some corporations have bought good will for a very large sum and within the next few years have written it entirely off their books. Other corporations carry the original expenditure as a capital asset. To go back to the original investment in each case is to treat essentially like situations differently; to introduce distinctions so capricious as to be maddening; to discriminate in a way that raises the gravest questions concerning the constitutionality of such treatment.

My own belief is that the most practicable treatment yet suggested for this situation is a valuation of capital assets as of some date, say January first, preceding the war. We must get rid of the war, that greatest of all abnormalities. To some degree this solution has been utilized in the capital definition adopted in the Excess Profits Tax Act of October 3, 1917. Tangible property paid into a

corporation for stock may be valued with some reservations as of January 1, 1914. How far under this statute actual valuation may be substituted for original investment; how far Congress intended this substitution to be made and how far the courts will sustain a rigid insistence upon original investment values, are grave questions which cannot be answered at this time.

This much may be said, however: we must start with a practicable and reasonably equitable determination of normal capital value. Until this foundation of the tax has been built, and built upon rock, the excess profits tax can only be a temporary makeshift.